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No. 74-124

In The
Supreme Court of the United States

October Term, 1974

Blue Chip Stamps, et al.,

Petitioners,

v.

Manor Drug Stores, On Behalf of Itself and All Other Users of Blue Chip Stamps Who Were Entitled But Failed to Purchase Stock of Blue Chip Stamps.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE PETITIONERS IN RESPONSE TO THE BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

The Solicitor General has belatedly filed a brief for the Securities and Exchange Commission as *amicus curiae* supporting respondent Manor Drug Stores. Because the SEC calls flatly for abandonment of the purchaser-seller rule — unlike respondent's attempt to carve out an untenable exception to that rule — petitioners submit this reply brief.

I. THE POLICIES UNDERLYING SECTION 10(b) AND RULE 10b-5 ARE NOT SERVED BY PERMITTING NON-BUYERS TO SUE FOR DAMAGES.

From general statements about the philosophy of the 1934 Act the SEC leaps to the conclusion that rule 10b-5 is "to protect *all* persons . . . against making investment decisions on the basis of misleading or inaccurate information." (SEC Br. at 20.) And since, in the SEC's view, all persons are to be protected, it follows that non-purchasing offerees should be able to recover damages for violation of the rule.* (SEC Br. at 21.) The crux of the SEC's position is that to deny a non-buyer a damage remedy would "emasculate the securities laws." (SEC Br. at 23.)

Petitioners have already pointed out that section 10(b) and rule 10b-5 refer only to conduct in connection with the "purchase or sale" of securities and do not include within their express terms any reference to *offers* to sell or purchase. (Pet'rs. Br. at 31.)

In an effort to rewrite section 10(b) and rule 10b-5 to include offers within the scope of their prohibitions, the SEC for the first time in the long history of this case seeks to incorporate into them the language of section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). The SEC argues that section 17(a) expressly prohibits false or misleading statements "in the offer or sale of any securities," and that the SEC's declared purpose in adopting rule 10b-5 was to extend to purchasers of securi-

* The SEC relies upon *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971), for the proposition that since rule 10b-5 protects creditors of a defrauded seller of securities, it must also protect offerees who are defrauded into not buying securities. But in *Superintendent* the action was brought by one who legally stood in the shoes of the actual defrauded seller, and hence is completely consistent with the purchaser-seller limitation in damage actions.

ties the prohibitions on fraud that section 17(a) imposed upon sellers. (SEC Br. at 11-13; *see* Pet'rs. Br. at 18-19.)

The simple answer to the SEC is that section 17(a) expressly includes offers within its scope while section 10(b) and rule 10b-5 do not. This demonstrates graphically that when Congress intended to reach offers to sell, it knew how to do so in clear and unambiguous language.*

Even if 10(b) and 10b-5 could be read to include non-purchasers within their protective scope, that does not compel the conclusion that a private action for damages should be created for non-purchasers. Where, as here, a private cause of action is wholly a judicial contruct, it is incumbent upon the courts to weigh benefits and detriments in deciding whether, in what form, and under what constraints private litigants should be permitted to supplement the broad enforcement powers of the SEC. *See* Scott, *Standing in the Supreme Court — A Functional Analysis*, 86 HARV. L. REV. 645, 654 n.32 (1973); Note, 53 N.C.L. REV. 150 (1974); *cf. Chris-Craft Industries Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 359 n.11 (2d Cir. 1973). It is this type of measured analysis that underlies the lower court decisions permitting non-selling investors (*i.e.*, those already owning stock in a company) to sue for injunctive relief, but not damages. (*See* Pet'rs. Br. at 31-32.) And it is this approach that has led the courts to reject consistently the SEC's broadside attack on the purchaser-seller rule. (*See* Pet'rs. Br. at 21 n.18.)

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* The Commission further suggests that the phrase "in connection with" the purchase or sale of securities (used in section 10(b) and rule 10b-5) is somehow broader than section 17(a)'s use of the phrase "in" the offer or sale of securities, and concludes that this makes it unnecessary for 10(b) and 10b-5 expressly to include offers within their reach. (SEC Br. at 12-13.) The SEC cites no apposite authority for this illusory grammatical distinction.

The SEC has conceded that practical adverse effects would flow from abolition of the purchaser-seller rule. (SEC Br. at 7, 24-28, 32-33.) This leads the SEC to suggest that two limitations are necessary upon the expansive resultant damage liability to which issuers would be subject. *(Id.)* The "limitations" the SEC sketches are ill-defined, unrealistic and ineffective — and would undoubtedly produce only more litigation respecting the scope of the limitations.

The first limitation would impose, in certain circumstances, an enhanced burden of proof upon plaintiffs who claim they would have bought or sold had they known the true state of affairs respecting the securities in question. (SEC Br. at 24-26.) The SEC suggests that where no "direct relationship" exists between the offeror and the offeree, the plaintiff may have to carry a "heavier burden of proof," *e.g.*, to offer "corroborative evidence" that "tends to show" that his "investment decision" was affected by a misstatement or omission. (SEC Br. at 25-26.)

With evident satisfaction the SEC asserts that under this limitation not every damage claim by a non-purchaser or non-seller would go to the "finders of fact"; rather, only those cases where the non-purchasing, non-selling plaintiff was an "owner of securities or a person to whom an offer to buy or sell had been directed." (SEC Br. at 26.)

The SEC's limitation is illusory. It would apply only when no "direct relationship" existed between the offeror and offeree. But apparently the SEC would find such a relationship and presume causation in all cases where the offerees could be identified. (SEC Br. at 26 n.31.) Thus, the limitation would not apply to the typical underwriting transaction by which most securities are

offered. (Pet'rs. Br. at 28-30.) Even where the proof limitation would apply, the SEC would require only some "corroborative evidence" that "tends to show" that the non-purchaser's investment decision was affected. And the SEC indicates that receipt by an offeree of a prospectus containing material misstatements or omissions would suffice for "corroborative evidence." (SEC Br. at 26 & n.31.) Yet the mere receipt of a prospectus, a press release or some other document says nothing about whether it was read, whether the recipient seriously considered purchasing (as opposed to building his litigation files), or even had the financial capability to buy.

The SEC admits that the reason for such a limitation is to provide some method of filtering out short of full trial that category of cases most likely to contain spurious claims. *(Id.)* There is, however, nothing in the proposed limitation that would permit summary disposition of cases. For example, it would still allow any member of the typically broad class of persons receiving a prospectus to impose upon the issuer the burden of trial on the merits and the risk of substantial liability, regardless of the offeree's ultimate ability to prove his claim.

The second so-called "limitation" proposed by the SEC would impose vicarious liability only where a corporation has benefited from the "wrongful acts of its officers or agents." (SEC Br. at 27-28.) In proposing this limitation the SEC recognizes the unfairness that damage suits by non-purchasers may work on actual investors. *(Id.)* Specifically, non-buyers will be able to sit on the sidelines, watch a stock's course, and then sue and perhaps recover huge damage awards which ultimately will be paid out of the pocket of the company to the detriment

of those who actually invested and put their funds at risk. (SEC Br. at 30-31; *see* Pet'rs. Br. at 33, 41-42.)

The SEC's proposed vicarious liability limitation overlooks the express provisions of section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a). This section imposes upon "control" persons (including corporations) vicarious liability for acts of controlled persons (including corporate officers or directors). *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 601-08 (1972); Note, *The "Controlling Persons" Liability of Brokers-Dealers for Their Employees' Federal Securities Violations,* 1974 DUKE L.J. 824. In view of this plain congressional policy, it would be wholly inappropriate to circumscribe vicarious liability judicially.

II. THE SEC CANNOT RECONCILE THE CONFLICT WITH THE 1933 ACT THAT WOULD RESULT FROM ABANDONMENT OF THE PURCHASER-SELLER RULE.

The SEC fails to reconcile the conflict between the 1933 and 1934 Acts which would result from abandonment of the purchaser-seller limitation where a "pessimistic" prospectus is at issue. (*See* Pet'rs. Br. at 36-42.) The SEC argues that the prospectus preparer's legal duty under the 1933 Act remains fixed regardless of who can sue for damages (SEC Br. 29 & n.35.) and hence that the "conflict" is irrelevant.

This position is incompatible with the SEC's concession that the 1933 Act's registration provisions embody a "conservative philosophy" toward prospectus drafting and that in complying with this policy "there may be a tendency to overstate risks . . ." (SEC Br. 28, 29 n.35.) Aban-

donment of the purchaser-seller rule in private damage litigation would inevitably undermine the "conservative philosophy" of the 1933 Act by threatening draconic liability for any "tendency to overstate risks."

The SEC soothingly reassures that "it is doubtful that any court would find it appropriate to impose liability upon an offerer who tends somewhat to understate the merits of the securities he is honestly trying to sell, so long as no truly material falsehood or omission is involved." The SEC distinguishes the instant case by inferring a "motive" to discourage sales from the allegation in the complaint that it was not in petitioners' interest to sell the securities. (SEC Br. at 28-29.) The SEC's "motive" test offers no protection to an issuer seeking to comply with the conservative philosophy of the 1933 Act. Motive is not an element of a 10b-5 action. (Pet'rs. Br. at 34-35, 22 n.19.) *See, e.g., Marx v. Computer Sciences Corp.*, 507 F.2d 485, 490 (9th Cir. 1974); *White v. Abrams*, 495 F.2d 724, 730-34 (9th Cir. 1974). Accordingly, there is no room for a trial court to find it not "appropriate" to impose 10b-5 damage liability upon an issuer for an unduly conservative prospectus.

III. SECTION 12(2) PROVIDES THE ONLY PRIVATE RIGHT OF ACTION FOR DAMAGES UNDER SECTION 17(a) OF THE 1933 ACT.

The Commission suggests in a footnote that even if the purchaser-seller rule precludes suit under 10b-5, respondent's "only error in the district court was in failing to allege a cause of action predicated upon Section 17(a) of the Securities Act." (SEC Br. at 12 n.10.) The SEC ignores the weight of authority that there is no private right of action for violation of section 17(a) apart from

the cause of action expressly created by section 12(2) of the 1933 Act, 15 U.S.C. § 77*l*(2). The detailed and delicately balanced provisions of section 12(2)* demonstrate that Congress gave careful consideration to the extent to which civil liability should be imposed for violations of section 17(a). Consequently, there is no basis for judicial implication of an additional remedy for violation of section 17(a), especially one which would nullify the restrictions imposed by Congress under section 12(2). As Judge Friendly has noted,

> "there is unanimity among the commentators, including some who were in a particularly good position to know, that § 17(a)(2) of the 1933 Act — indeed, the whole of § 17 — was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§ 11 and 12." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (concurring opinion), *cert. denied*, 394 U.S. 976 (1969).**

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* "Any person who . . .

> "(2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, *shall be liable to the person purchasing such security from him*, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." (Emphasis added.)

** Among those "in a particularly good position to know" was Mr. Justice Douglas, who wrote shortly after passage of the 1933 Act that "[s]ection 17 probably does not enlarge civil remedies

Those courts which have given the question thorough consideration have almost unanimously agreed that section 17(a) creates no private cause of action independent of the remedy provided by Congress in section 12(2). *See, e.g., Greater Iowa Corp. v. McLendon,* 378 F.2d 783, 788-91 (8th Cir. 1967) (Gibson, J., joined by Blackmun & Mehaffy, J.J.); *Simmons v. Wolfson,* 428 F.2d 455, 456 (6th Cir. 1970), *cert. denied,* 400 U.S. 999 (1971); *Trussell v. United Underwriters, Ltd.,* 228 F.Supp. 757 (D. Colo. 1964); *Dyer v. Eastern Trust & Banking Co.,* 336 F.Supp. 890 (D. Me. 1971); *Hardy v. Sanson,* 356 F.Supp. 1034 (N.D. Ga. 1973).

Contrary to the SEC's assertion, these cases have not simply "applied the *Birnbaum* doctrine to actions brought under Section 17(a)," nor have they "disregard[ed] even the unambiguous expression of congressional purpose" behind section 17(a). (SEC Br. at 12 n.10.) Rather, the courts correctly have held that section 12(2) provides the only private cause of action for violation of section 17(a), and that this remedy is expressly limited to actions by "the person purchasing such security . . . to recover the consideration paid . . . ."

Moreover, the SEC is mistaken in stating that respondent here erred "in failing to allege a cause of action predicated upon Section 17(a)." (SEC Br. at 12 n.10.) Respondent did allege such a cause of action by asserting a claim under section 12(2) — a claim which was properly dismissed by the district court on the ground that plaintiff was not a purchaser. (App. at 127.)

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of purchasers. This seems clear by negative implication, since Sections 11 and 12 expressly state the remedies which are available." Douglas & Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171, 181-82 (1933). *See also* 3 L. Loss, SECURITIES REGULATION 1784-85 (1961).

IV. THE PURCHASER-SELLER RULE IS SOUND AND SHOULD BE RETAINED.

Petitioners have previously noted the detrimental consequences which would flow from abandoning the purchaser-seller rule — increased liability exposure, enhanced risk of strike suits, extortionate pressure for nuisance settlements of large magnitude. (Pet'rs. Br. 28-30, 34-36, 40-42.)

By contrast, retention of the purchaser-seller rule does not leave an allegedly defrauded non-purchaser without remedy. Common law fraud remedies are available whenever a deliberate misrepresentation has occurred, and respondents have just such an action pending against petitioners in the California state court. (Pet'rs. Br. at 49 n.34.)

Weighing the practical detriments which would result from accepting the SEC's position against the theoretical benefits of "potential investor" protection, it is plain that the purchaser-seller rule should be retained. The rule well fulfills the purposes of section 10(b) and rule 10b-5. The SEC has statutory "standing" to bring broad-ranging injunctive actions against deceptive practices that have harmed or have the prospect of harming actual or potential purchasers or sellers. An existing investor may bring an action for injunctive relief against deceptive practices in connection with purchases and sales of securities. (*See* Pet'rs. Br. at 22, 32.) Finally, one who takes the plunge and becomes a "purchaser" or "seller" of securities can bring an action for damages allegedly suffered because of deceptive practices.

The judicial evolution of the purchaser-seller rule has resulted in a rational framework for the vindication of the section and rule's policies. And the lower courts can be counted on to continue to adapt the doctrine to new

situations as they are presented. Despite the SEC's position, a quarter century evolution of the purchaser-seller rule has not "emasculated" 10b-5, but has effectuated its purposes.

Respectfully submitted,

ALLYN O. KREPS
MICHAEL D. ZIMMERMAN
611 West Sixth Street
Los Angeles, California 90017

Attorneys for Petitioners Blue Chip Stamps, Blue Chip Stamp Company, Alexander's Markets, Lucky Stores, Inc., Purity Stores, Inc., Ralphs Grocery Company, Safeway Stores, Inc., Thriftimart, Inc., Thrifty Drug Stores Co., Inc., Vons Grocery Co., Robert E. Alexander, Donald A. Koeppel, Leonard H. Straus, William F. Ramsey, Robert E. Laverty, Richard Ralphs, John R. Niven and Fred Von der Ahe.

G. RICHARD DOTY
3435 Wilshire Boulevard
Los Angeles, California 90010
Attorney for Petitioner Market Basket

Of Counsel:
THOMAS J. READY
O'MELVENY & MYERS
MCCUTCHEN, BLACK, VERLEGER & SHEA

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